



D'ALOIA V PERSONS UNKNOWN: CRYPTO TRUSTS, UNJUST ENRICHMENT AND THE CHALLENGES OF TRACING ON THE BLOCKCHAIN

The English courts have dealt with a steady stream of cases arising from crypto frauds and it has been through these cases that the law on digital assets has developed. However, many of the well-known decisions in this area to date have been interlocutory, often without the benefit of the court hearing from both parties. A recent High Court judgment following a trial of claims against a crypto exchange is therefore timely.¹

The element that has grabbed headlines is that the judge recognised Tether ("USDT") as a distinct form of property (neither a chose in action nor a chose in possession), consistent with the Property (Digital Assets etc) Bill published in July. However, more importantly (and making it of much more general application), the judgment considered the reasons why in some detail and engaged with the Law Commission Report "Digital Assets: Final Report" published on 27 June 2023 (the "Final LC Report").

The judgment is also important in that it explores some key consequences of USDT being property, such as how the rules on tracing apply and when crypto exchanges may be considered constructive trustees or liable to make restitution for unjust enrichment. It is a rich source of practical guidance for those involved in the crypto sector and more broadly for any party tracing assets or the proceeds of fraud which have been converted into crypto.

What makes this a significant judgment?

- **It explores the nature of the property in cryptocurrency:** Property rights attached to the USDT itself, rather than the right to control it. USDT was neither a chose in action nor a chose in possession, but rather a distinct form not premised on an underlying legal right.
- **It identifies when following and tracing can be applied to transfers on a blockchain:** Claimants may be able to use following rules if specific cryptoassets remain identifiable following transfer but typically will need to use tracing rules and, unless equitable tracing applies, will be unable to trace through wallets holding cryptoassets from multiple sources (i.e., "mixed funds"). However, it also highlights how claims in unjust enrichment may be circumvent some of those strict rules.
- **It discusses appropriate methodologies for blockchain analytics evidence:** Claimants must present cogent expert evidence based on a transparent methodology that also strikes a fair balance between multiple fraud victims.
- **It progresses the debate on crypto exchanges being constructive trustees:** The fraudsters were constructive trustees and the Exchange (had the Claimant's expert evidence been accepted) took title to the USDT subject to the Claimant's equitable interest. The Exchange was held not to be a constructive trustee itself. However, while no knowing receipt claim was pleaded, the Court did not dismiss entirely the argument that an exchange which acts in a commercially unacceptable manner would be a constructive trustee.
- **It demonstrates the importance of AML compliance in a private law context:** The Exchange was deprived of key defences to the constructive trust and unjust enrichment claims because it failed to block the account following blatant signs of suspicious use.

¹ *D'Aloia v Person Unknown* [2024] EWHC 2342 (Ch), judgment given by Richard Farnhill sitting as a Deputy High Court Judge.

The Facts

- The Claimant was the victim of a scam involving a sham online investment website, to which he had transferred around £2.5 million in cryptocurrency, a portion of which was USDT.
- The Claimant provided expert blockchain analytics evidence that his USDT was then moved through a series of wallets and withdrawn as fiat currency through various crypto exchanges.
- This trial concerned just one exchange, Bitkub (the "**Exchange**"). The Claimant's expert said that following a series of 14 "hops" between different wallets, some 400,000 USDT including some of the Claimant's reached a wallet provided by the Exchange to a Ms H before being swept into the Exchange's hot wallet.
- Under the Exchange's KYC process, Ms H declared her income as between 15,000 - 29,999 THB per month and so was subject to a daily withdrawal limit of 2 million THB. However, Ms H very quickly converted that amount into fiat currency (13 million THB).
- The Exchange's system should have prevented the transfers and blocked the account but failed to do so for reasons the Exchange was unable to explain (a key fact in the case).

The Claimant claimed against the Exchange in unjust enrichment and (although there was some debate as to exactly what claims were advanced) made equitable property claims alleging various constructive trusts. The Claimant secured permission to serve proceedings on the Exchange on the basis of the alleged constructive trust.²

Why does USDT constitute property?

The court did not strictly need to consider the issue because neither party disputed that USDT was property. However, the judge said it was necessary because the nature of the property rights in USDT (if any) was important to issues that were in dispute concerning tracing through a mixed fund. The judge was careful to note that his conclusions applied to the facts of the case and to USDT rather than cryptoassets generally. Nevertheless, the conclusions provide a helpful precedent in relation to the following key propositions.

USDT attracts property rights under English law, i.e. a person can have a proprietary interest in USDT, rather than just a contractual claim to USDT

Much of the reasoning was based on the conclusions in *Tulip Trading*,³ on the premise that the underlying systems supporting and recording USDT are similar to the BTC arrangements considered in *Tulip Trading*. The judge also quoted with approval the Final LC Report: "*In England and Wales ... there is now a persuasive, clear, and well-reasoned body of case law that concludes that certain digital assets are capable of being objects of personal property rights*", and "*Those things [crypto tokens] do not exist as rights or claims in themselves (they instead exist independently). They also can be used and*

² *D'Aloia v Person Unknown & Ors* [2022] EWHC 1723 (Ch) para 24

³ *Tulip Trading v Van der Laan* [2023] EWCA Civ 83

enjoyed independently of whether any rights or claims in relation to them are enforceable by action", noting that "This, it seems to me, is both right and significant in the analysis: cryptoassets have a conceptual existence that is independent of the legal system and of their individual users." (para 113, 114, 115)

The judge also observed that the starting point (and "*also, often ... the end point*") for considering whether a cryptoasset is a form of property is the test in *National Provincial Bank v Ainsworth* [1965] AC 1175 at 1247-1248 ("*Before a right or an interest can be admitted into the category of property, or of a right affecting property, it must be definable, identifiable by third parties, capable in its nature of assumption by third parties, and have some degree of permanence or stability.*") (para 145, 153) Also, a key consideration was that cryptoassets like USDT are "*rivalrous, that is to say ownership by one person prevents ownership by another*" (para 112).

The property rights attach to the USDT itself, rather than the right to control it, for example the right to use the private key

This is interesting, because the judgment includes discussion of the concept of a private key in some detail and in practice it is unclear how a person can be regarded as the legal owner of a digital asset without holding the private key, and it raises the question of who is the legal owner of a digital asset where the private key is shared. This issue will be central in any future ownership disputes.

USDT is neither a chose in action nor a chose in possession, but rather a distinct form of property not premised on an underlying legal right

The judge was clear that USDT was not a chose in action since there were no rights to claim against a third party, but this did not matter because the cryptographic security of the blockchain meant there was an expectation that transactions would be honoured (para 155). The judge also noted that it was not correct that cryptoassets were merely information, since cryptoassets were not merely data but a combination of data and the transactional functionalities related to it. (para 159)

Interestingly, the judge cast doubt on the concept of a single "third category" for assets which were not choses in action or choses in possession, stating "I would not seek to bracket all assets that are neither choses in action nor choses in possession under a single category of property for all purposes" and observed that this view "is consistent with the approach proposed in the Law Commission's draft Property (Digital Assets etc) Bill." (para 153(iii))

The impact of the Property (Digital Assets etc) Bill is neutral

The judge noted the Bill (as set out in the Law Commission paper entitled "Digital assets as personal property: Supplemental report and draft Bill", Law Com No 416, published 29 July 2024), but said it had limited effect on his decision given that it simply clarified that something can be property even if neither a chose in action nor a chose in possession, observing that he considered this to be the right approach, since it is then for the courts to determine the rights and obligations of parties by reference to the particular facts of the case before them. (para 169, 172)

Can USDT be traced or followed into the hands of third parties?

The Claimant needed to show that the Exchange received his USDT. English law has fairly complex rules of tracing and following that claimants must follow to establish that their property (or its proceeds) reached the hands of a defendant. The terms are often (confusingly) used interchangeably.

- Following: where the property in question does not change but moves from "hand to hand". Following cannot be used in respect of choses in action and cannot be used when the property becomes mixed with other similar property and ceases to be identifiable.
- Tracing: If the property is exchanged or sold, then rules on tracing apply to the substituted assets (or cash). However, different rules apply at common law or in equity:
 - Common law tracing applies where a claimant has full legal title to the property, but no separate equitable interest, typically cases of misappropriation of funds.
 - Equitable tracing applies where a claimant has an equitable interest in the property, which in cases of fraud often arises from a constructive trust of the proceeds of the fraud. Equitable rules are more flexible than common law rules.

Fine distinctions between tracing in equity and common law have been much criticised as unfair and unprincipled (including by the House of Lords in *Foskett v McKeown*⁴), but remain for reasons explained in the judgment. The application of tracing and following rules to cryptoassets was considered in the LC Final Report, but the Law Commission left the development of the law in this area to the courts. *D'Aloia* is the first time the courts have grappled with some of the difficult legal issues associated with this, as well as the more practical issue of whether the Claimant had proved his factual case with his expert evidence.

Common law following could in principle be used but was not established on the evidence

To establish whether following was, in principle, available, the judge considered the nature of the proprietary interest, whether it was a chose in action or a chose in possession, and whether USDT can in fact be followed through a "mixed fund". The judge referred back to his conclusion that USDT was neither a chose in action nor a chose in possession and framed the question as, based on USDT's characteristics, simply "*how best to treat USDT for the purposes of following.*" The judge said it could apply for two reasons:

- USDT is more like a physical asset that retains its own identity in a mixture of other similar assets (rather than being "*mixed and confounded*") as Tether Ltd was said to be able to identify individual USDT in any wallet, albeit that point was not explored in any detail and the judge noted that Mr Justice Trower in *Piroozzadeh v Persons Unknown* said the task was "*possibly impossible*" (in the context of a hot wallet with very high volumes of transactions).

⁴ *Foskett v McKeown* [2001] 1 AC 102

- The judge preferred to characterise USDT as a "persistent thing" (para 208) rather than something that was extinguished and created upon transfer.

Whether data from Tether Ltd can be used as the judge envisaged remains to be seen. Following may also be possible for NFTs. But in either case, compelling blockchain analytics evidence is still required.

Common law tracing could not be used in principle

The judge held (although the parties seem to have agreed it) that the Claimant could not trace through a mixed fund at common law. That was fatal to any proprietary restitution claim (which the Claimant had in any event already withdrawn) and complicated the unjust enrichment claim (see below) because his USDT had been transferred through wallets likely containing other victims' USDT. This is an issue of significant academic interest given the debate as to whether there are (or should be) separate equitable and common law rules for tracing. The judge explained clearly why (obiter) comments in a leading House of Lords case do not mean there is no distinction, but this is an issue which is sorely in need of further consideration at an appellate level. From a practical perspective, to the extent a future case relies on common law tracing (where the claimant has no separate equitable interest) then this will be a key issue.

Equitable tracing rules clarified but Claimant's expert evidence failed to follow them

The Claimant's case based on constructive trust therefore rested on his ability to trace (using equitable rules) the USDT from the wallet to which he had originally made the transfer to the Exchange's hot wallet. The questions then became (i) the appropriate principled approach to take to tracing through mixed funds; and (ii) whether factually the Claimant's expert used an appropriate methodology.

- For mixed funds, the court seeks to balance the interests of equally innocent parties, and to ensure that the interests of one did not take precedence over the others. The judge identified three options: (i) "first-in-first-out" (the default option, but can be displaced); (ii) *pari passu* distribution; or (iii) the "rolling charge", but importantly said that (ii) and (iii) were not exhaustive alternatives to (i) as long as a method is used that "*treated all innocent claimants and potential claimants comparably and was properly evidenced.*"
- The judge found that the Claimant's expert did not use any of those options and, while that was not strictly necessary, he could not accept the expert evidence because it was unclear what methodology had been adopted. The expert purported to apply the "first in last out" methodology but did so with modifications. In particular, at times the expert sought to match outbound transfers with the inbound transfers and ignored other intervening inbound transfers (i.e. very much not first-in-first-out). Some of the "hops" did not accord mathematically with his stated methodology.
- There was also some criticism that he may have been overly reliant on the various specialist software products he deployed, which in any event produced different results. Ultimately, the judge felt the methodology used favoured the Claimant over other victims.

For these reasons, the judge did not accept that the USDT received by the Exchange was the Claimant's USDT. This was fatal to almost all of the claims.

Was the Exchange a Constructive Trustee?

The Claimant advanced his case on various grounds. The judge accepted that the original fraudster held the USDT on constructive trust as a result of the fraud at the point of transfer. In the alternative, a similar result would also be reached even if the original transaction was viewed as a contract based on fraudulent misrepresentation that the Claimant had rescinded by commencing proceedings. This part of the judgment is helpful in clarifying an issue which the courts have not had the opportunity to consider properly in interlocutory decisions.

The Claimant also argued that the Exchange itself was a constructive trustee because (broadly) its failure to operate AML controls meant it acted in a commercially unreasonable manner resulting in the receipt of the USDT being unconscionable (and thus forming the basis of a constructive trust). However, the judge did not decide this because he found that it had not been properly pleaded. It is unfortunate that the judgment did not explore this issue in more detail, as it is a popular argument with claimants.

Within that framework, the Claimant's pursuit of recipients of trust property could either take the form of an equitable proprietary claim for the return of trust assets in their possession, or a personal claim for knowing receipt or dishonest assistance if they had dissipated the assets. The former failed because the Claimant's USDT could not be traced to the Exchange and in any event the Exchange did not retain the alleged trust property (why exactly, and where the USDT was said to have gone, was not explored and this may be an issue that requires exploration in future cases). The latter did not arise as no knowing receipt claim was made.

However, if the Claimant had been able to trace his USDT to the Exchange, the situation may have been different. Among the consequences of the Exchange's failure to comply with its own systems and controls with respect to suspicious trading and AML and its resulting actual notice that Ms H's account was possibly being used for money laundering, the judge found this would have prevented the Exchange from relying on the defence of being a good faith purchaser for value without notice.

Did the Exchange have to make restitution to reverse its unjust enrichment?

The Judge held that the Exchange was enriched by receipt of the 400,000 USDT (which the expert concluded contained some of the Claimant's). The court also accepted the Claimant's submission that the "unjust" requirement for unjust enrichment was satisfied both because there was an unauthorised payment and because there was a payment by mistake.

The Claimant's claim failed because he could not show the Exchange had been enriched *at the expense of the Claimant*. Principally, that was because as a matter of law (i.e. application of common law tracing rules) he could not trace the USDT to the Exchange and could in any event not do so in fact because of the issues with the expert evidence. However, the Claimant had an alternative argument that the "hops" through mixed wallets should be treated as a single "sham", circumventing the need to apply strict tracing rules

and resulting in his properly being treated as having made a direct transfer to the Exchange.

In relation to the sham claim, the judge was willing to accept this could be possible because the Claimant had established a link between the unknown fraudsters and Ms H, who was either actively involved in laundering funds or, possibly, was a money mule. However, the judge considered that more than just a link between Mr D'Aloia and Ms H's user account was required – the expert's failure to show that Mr D'Aloia's USDT (as distinct from anyone else's) had actually reached Ms H's user wallet was ultimately as fatal to the unjust enrichment claim as the trusts claim

Finally, the judge went on to consider two key defences for completeness:

- The defence of good faith change of position to an unjust enrichment claim was not available to the Exchange because it had failed to discharge the evidential burden of showing good faith. The judge considered (as discussed above) that the Exchange had actual notice of suspicious activity on H's account and so could not rely on a good faith defence.
- The judge recognised that the defence of ministerial receipt should be available in principle to receipts of cryptoassets. However it would not apply to the Exchange principally because at the time of paying away the relevant funds to Ms H it was not acting in good faith; it had actual notice of suspicious activity on her account.

This shows the importance, beyond mandatory regulatory requirements, of crypto exchanges ensuring they have in place robust account monitoring systems and operating them effectively.

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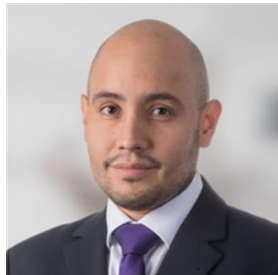
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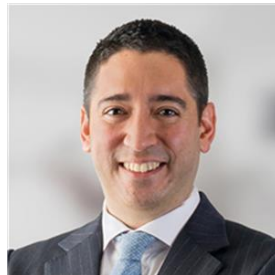
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